BENEFIT-OF-THE-

BENEFICIARY RULE

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In July 2018, Florida joined a growing group of states that have eliminated or severely curtailed the so-called Benefit-of-the-Beneficiary Rule from its trust code. See Fla. Stat. §§ 736.0103(11), 736.0105(2)(c), 736.0404 (2018). Other state bar organizations that are currently preparing legislation to adopt parts of the Uniform Trust Code (UTC) have decided to forego adopting the Benefit-of-the-Beneficiary Rule. See H.B. 1471, 101 Gen. Assembly, at pages 11-12 (Ill. 2019 and 2020). What is this rule and why has it become so controversial?

As estate planners, most of us have our fingers on the pulse of the latest tax court cases and IRS rulings that affect the planning techniques on which we all rely. Many of us, however, are unaware of a shift that is taking place in trust law that may make it impossible for these techniques to continue. For example, regardless of the language our trusts contain, basic tax planning strategies such as life insurance trusts and GRATs may be shut down—not by a change in the tax law or the IRS but by a little-known trust law known as the Benefit-of-the-Beneficiary rule—a mandatory rule promulgated under the UTC. The debate over this rule has largely been confined to the halls of academia, although there is now litigation based upon fiduciaries breaching this mandatory rule. But with real world effect on our planning, the authors wish to bring the rule to the attention of practitioners who can work to stop it in its tracks through their bar associations and state legislatures.

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There has always been an underlying friction in American trust law—a tension between balancing the wishes or directions of the grantor against the beneficiary's equitable interests in the trust. This tension is a natural effect of the essential nature of trusts, in which the grantor transfers legal title of assets to the trustee and the equitable interests to the trust beneficiaries. This division between the management of the trust assets and the beneficial enjoyment of the trust assets creates an environment rife for conflicts. Balancing these inherently competing interests is a central issue that has remained prevalent during trust administration. Lee-ford Tritt, *The History, Impact, and Future of the Benefit-of-the-Beneficiary Rule: Parts I & II*, in Edward F. Koren, *Estate, Tax and Personal Financial Planning* (update Dec. 2014/Jan. 2015). If there is a conflict between these two competing interests, should the interests of the property-owner (the grantor) take priority over the interests of the beneficiary?

Historically, with donative freedom as the foundation of American trusts and estates law, American trust law has long favored the grantor. The organizing principle behind our pro-grantor jurisprudence law is that the "donor's intention is given effect to

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the maximum extent allowed by law." *Restatement (Third) of Prop.: Wills and Other Donative Transfers* § 10.1 (2011). This is reflected in the General Comment to UTC Article 8 and UTC 801 (Duty to Administer Trust), which describes an overarching duty to fulfill donative intent. As a result, fiduciaries have a fundamental obligation to follow the terms of will or trust agreement.

Currently underway, however, is a shift away from the principle of protecting donative intent towards the concept of protecting the beneficiary's perceived interests. This shift is in line with the growing number of mandatory rules in trust law that were enacted to effectuate the grantor's intent (such as UTC § 105, Default and Mandatory Rules) and is partially reflected in the Benefit-of-the-Beneficiary Rule of the UTC. The UTC governs the law of trusts where it has been adopted, including over 30 states and the District of Columbia.

The Benefit-of-the-Beneficiary Rule provides that a "trust and its terms must be for the benefit of its beneficiaries." The rule is found in two sections of the uniform trust code: (1) UTC § 105(3), which provides that "the terms of the trust if a trust prevail over any provisions of this [Code] except . . . the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;" and (2) UTC § 404 which provides "[a] trust and its terms must be for the benefit of its beneficiaries." UTC § 105(3) (2006); UTC § 404 (2006). This is a mandatory requirement that the grantor cannot waive or draft around. In addition to its codification in the UTC, the Benefit-of-the-Beneficiary Rule has also been endorsed by one of the most authoritative sources concerning American trust law—the *Restatement (Third) of Trusts. Restatement (Third) of Trusts* § 27 (2011). Although seemingly innocuous by its terms, the Benefit-of-the-Beneficiary Rule jeopardizes all areas of estate planning—including tax planning, closely held businesses, investment directives, spendthrift provisions, and conditional gifts—just to name a few. As a result, the effect of the rule is greater when analyzed in combination with the adoption of other pro-beneficiary rules.

Historic Deference to the Settlor

Historically, under American estate and trust law a person could dispose of her property subject to whatever restrictions and limitations she saw fit so long as it was not contrary to the law or against public policy. See, e.g., *Shelton v. King*, 229 U.S. 90, 100 (1913). Many of us recall the amusing cases from our trusts and estates class in law school in this area. For example, the cases that dealt with the willful destruction of property—such as the direction in a will to burn the testator's money (see, e.g., *In re Estate of Feinberg,* 919 N.E.2d 888, 890 (Ill. 2009)) or brick up her house (see, e.g., *Brown v. Burdett*, 21 Chan.Div. 667 (Eng.1882)), the cases that dealt with illegal activity—trusts could not be used to pay bribes or to violate banking laws (see, e.g., *Thrupp v. Collett*, 53 Eng. Rep. 844 (M.R. 1858)), the cases that found that the grantor's intent could be circumvented if it violated public policy such as provisions that encouraged divorce (see, e.g., *Pattee v. Riggs Nat'l Bank of Wash., D.C.*, 124 F. Supp. 552, 554 (D.C 1954); *Graves v. First Nat'l Bank*, 138 N.W.2d 584, 588-92 (N.D. 1965)) or interfered with mother-child relationships (*In re Carples' Estate*, 250 N.Y.S. 680, 681-89 (Sur. Ct. 1931)), and the myriad of religious freedom cases in which restrictions against marrying outside of the faith were typically upheld only if the child lived in an area where he or she could find a spouse of that religion (see, e.g., *Shapira v. Union Nat'l Bank*, 315 N.E.2d 825, 830 (Ohio Ct. Com. Pl. 1974); *In re Estate of Feinberg,* 919 N.E.2d at 890).

With the exception of these public policy cases, in which the grantor's wishes were invalidated, American trust law has long favored giving preference to the grantor's intentions. This is unlike English trust law, from which our laws derived. Our departure from the English law stems from the seminal case *Claflin v. Claflin*, decided by the Massachusetts Supreme court in 1889. In *Claflin*, the beneficiary was not to receive payment from the trust until he reached the age of 25 and sued to have the trust terminated earlier (*Claflin v. Claflin*, 20 N.E. 454 (Mass. 1889)). The court rejected English precedent, which would have allowed the early termination, and instead found that the "Testator has a right to dispose of his own property with such restrictions and limitations, not repugnant to law, as he sees fit, and that his intentions ought to be carried out, unless they contravene some positive rule of law, or against public policy." Id. at 456.

The so called *Claflin* doctrine arose from *Claflin* and was historically one of the two ways a trust could be modified under US trust law. Under the *Claflin* doctrine, a trust could only be modified or terminated by a court if (i) all beneficiaries consented and (ii) the termination or modification was not contrary to a material purpose of the trust—which includes a trustee having discretionary authority over distributions of principal and income or a spendthrift provisions in the trust. As a result, trusts with these provisions became known as "indestructible trusts"—ones that could not be terminated by the *Claflin* doctrine. William F. Walsh, *Indestructible Trusts and Perpetuities in New York*, 43 Yale L.J. 1211, 1218 (1934). With creditor protection as an essential part of estate planning, just about all trusts today contain spendthrift provisions and, as a result, are indestructible under the *Claflin* doctrine.

The other historic method of terminating or modifying a trust is under the equitable deviation doctrine, in which a trust can be changed if circumstances unanticipated by the settlor would defeat or substantially impair the purposes of the trust. Under this doctrine, the settlor's intent is paramount, and trusts may be modified, if necessary, to carry out the settlor's intent. This doctrine came from *In re Pulitzer's Estate*, 249 N.Y.S. 87, 98 (N.Y. Sur. Ct. 1931), in which the New York Surrogate's Court in 1931 allowed the trustees to sell stock in a newspaper that was going bankrupt despite the investment direction in the trust to never sell the stock. The court permitted the sale because it found that the settlor's primary intent in creating the trust was to pass wealth to his descendants and to ensure that the corpus was there for the remainderman. The court explained that the settlor never could have imagined that the newspaper would suffer such losses. These circumstances—which never were anticipated by the settlor—justified the modification of the trust term to never sell the newspaper stock.

Although we often think of decanting as a way to modify a trust, it is not. Instead, decanting allows a trustee who has a power to appoint trust property to a beneficiary outright to instead appoint it further in trust for the benefit of the beneficiary. This was limited in the common law to completely discretionary trusts, where the grantor gave the trustee complete discretion over when trust property could be distributed. Decanting thus was consistent with upholding the grantor's intent and was recently expanded in many states through the adoption of legislation.

Benefit-of-the-Beneficiary Rule

In sharp contrast to the jurisprudential genesis of our historic trust law, the Benefit-of-the Beneficiary Rule was born through the work of the American Law Institute in the *Restatement (Third) of Trusts* and the National Committee Uniform State Laws in the UTC. These two prominent voices in shaping American laws seemingly developed the rule based, not on a shift in case law, but rather on a preference for ending dead hand control over trusts. The *Restatement* provides "a private trust, its terms, and its administration must be for the benefit of its beneficiaries…." *Restatement (Third) of Trusts* § 27(2) (2011). The UTC provides "a trust and its terms be for the benefit of the beneficiaries." UTC § 105(a)(3) (2006). The only authority that the *Restatement* cites for the rule is the UTC, and the only authority that the UTC cites for the rule is the *Restatement*. See UTC § 404 cmt. (2006); *Restatement (Third) of Trusts* § 27 (2011). Their Benefit-of-the-Beneficiary Rule, along with their concept of administrative deviation—the greater ease in which beneficiaries may prematurely terminate a trust—and their weakening of spendthrift provisions, pushes the pendulum of trust law from deferring to settlor's intent to favoring the beneficiaries.

The debate concerning the Benefit-of-the-Beneficiary Rule was promulgated by Professor John Langbein, who opined that the new rule would greatly affect many areas of trust law, especially in areas where deference was given to the grantor. Lee-ford Tritt, *The History, Impact, and Future of the Benefit-of-the-Beneficiary Rule: Parts I & II*, in Edward F. Koren, *Estate, Tax, and Personal Financial Planning* (update Dec. 2014/Jan. 2015). In turn, for example, it would allow courts to invalidate grantor trust directives more frequently. Id. Professor Langbein argued that this shift in protecting the beneficiary's interests over the grantor's desires would be a just result. Id. Proponents of the Benefit-of-the-Beneficiary Rule also contend that the rule does not deviate from current trust law but instead simply codifies our current case law against unlawful trust activity, capricious purposes, and trusts that violate public policy. Upon close examination of the details of the rule, it goes far beyond that. Trust provisions must now be viewed through the lens of whether the trust and its provisions are beneficial to the beneficiary—regardless of the settlor's intent. The rule effectively places an outside limit on our historic deference to the settlor's intent whenever a trust provisions does not benefit the trust beneficiary. As a result, it goes beyond invalidating crackpot trusts to limiting a settlor's ability to mandate specific trust terms or guidelines.

Specifically, the UTC § 412 comment acknowledges that this provision "does not have direct precedent in the common law" and explains that "[a]n owner's freedom to be capricious about the use of the owner's property ends when the property is impressed with a trust for the benefit of others." The comment explicitly acknowledges a departure from case law, in which trust provisions can be modified even when circumstances have not changed, and it is exactly what the settlor intended if those provisions are shown to impair the trust's administration or impose unreasonable restrictions on property.

In addition, the comment to UTC § 404 provides further background. Specifically, it states that "[s]ection 412(b), which allows the court to modify administrative terms that are impracticable, wasteful, or impair the trust's administration, *is specific application of the requirement that a trust and its terms be for the benefit of the beneficiaries*." 404 cmt. (emphasis added). The implication of this section grants courts the ability to modify the trust if the terms do not benefit the beneficiary. Furthermore, the *Restatement (Third) of Trusts* §65(2) provides that the beneficiaries can compel the modification or termination of a trust after the settlor's death "with authorization of the court if it determines that the reason(s) for termination or modification outweigh the material purpose" of the trust. *Restatement (Third) of Trusts* § 65(2) (2011). UTC § 411 also provides that a spendthrift provision is not presumed a material purpose; instead, it is a question of the settlor's intent. Id. The implication is that a spendthrift clause without other evidence of intent to protect assets will not be a material purpose of the trust.

Effect on Estate Planning Techniques

The Benefit-of-the-Beneficiary Rule narrowly defines "benefit" to mean wealth maximization. This wealth maximization theory, combined with modern portfolio theory endorsed by the drafters of the rule, discounts other reasons why clients create trusts. Clients may create trusts that not only financially benefit the beneficiaries, but also personally and perhaps spiritually support the beneficiaries. There are many worthwhile goals in creating trusts other than wealth maximization. As a result, trust provisions often reflect both the settlor's ideas about investment strategies and the settlor's moral or religious beliefs. Settlors may also create provisions that incentivize beneficiaries or merely create a fallback cushion.

Additionally, the ability to negate a trustee's duty to diversify would likely come to an end with the Benefit-of-the-Beneficiary Rule. Under the Uniform Prudent Investor Act, the default rule is that a trust must be diversified. Prudent investing calls for diversification, but in recognizing there may be circumstances where diversification does not make sense, the settlor can draft around it by explicitly waiving the duty to diversify and may also provide that a specific investment be retained. The comments to the Benefit-of-the-Beneficiary Rule, however, provide that an objective test must be used to determine whether an investment restriction maximizes the beneficiary's wealth. Under the rule, a settlor's decision to negate the duty to diversify would be upheld only when doing so would economically benefit the beneficiary. Any trustee worried about liability will likely be compelled to diversify despite retention clause language.

For instance, the settlor may want to achieve personal benefits for the beneficiaries and require that a trustee retain a vacation home so that the family could continue to spend time together after the settlor's passing. The settlor's intention with such a trust may be to protect and preserve the family—not to protect and preserve the assets. Similarly, waiving the duty to diversify in a trust that holds the family business is typically not motivated solely by wealth maximization. Often the family business provides employment for family members who may or may not be the beneficiary of a particular trust. It is also a source of pride and unifying center for a family. Similar restrictions on trust investments may be motivated by the settlor's spiritual or moral benefits in restricting types of investments. Again, with the Benefit-of-the-Beneficiary Rule, the motivations or intentions of the settlor are irrelevant. Rather, the economic benefit and wealth creation for the beneficiary is the only inquiry.

Another major reason why settlors create trusts is for tax planning purposes. Essential to many of these techniques is the ability to draft around the duty to diversify. One of the most popular and common tools is a life insurance trust. As its name indicates, it is designed for the very purpose of holding life insurance on the settlor's life. When viewed in the narrow lens of the modern portfolio theory, however, it might not be economically prudent to the beneficiary to invest the trust's funds in the sole asset of a life insurance policy that may not come due for decades. Trustees of a life insurance trust could face real liability by continuing to invest trust funds in such a policy despite the settlor's clear intention and purpose for the trust. As such, with this type of liability risk, it may be hard to find trustees who are willing to serve over a life insurance trust, making it impossible (or at the very least expensive by having to pay a corporate trustee in a state friendly to a settlor's intent) to use life insurance trusts. A strong advocate of the rule addressed this criticism by explaining that a life insurance trust may be in the best interests of the beneficiary if it were "deployed as part of a suitably diversified, multi-asset estate plan." John H. Langbein, *The Uniform*

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Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641, 646 (1996). This answer provides little comfort to planners because many clients use life insurance trusts as their first, and often their sole, lifetime planning vehicle.

Another popular lifetime tax planning vehicle is the GRAT. Specifically set forth in the IRC, it is one of the most attractive estate planning tools available to a wealthy settlor. Investment volatility enhances the potential estate planning benefits of the technique, and, to maximize the volatility, a GRAT portfolio typically is not diversified. Unfortunately, as logical as it may be from an estate planning and transfer tax perspective, GRAT investing is contrary to modern portfolio theory and thus defies the Benefit-of-the-Beneficiary rule. With the Benefit-of-the-Beneficiary Rule, the trustee will have to do the unthinkable—immediately sell the stock and diversify.

Unintended Consequences of the Rule

Reasonable minds may differ as to what the rule is intended to change or clarify, but there is no doubt the very existence of the commentary contained in the UTC and the *Restatement* will be used by beneficiaries to circumvent the settlor's intent and have trusts changed or terminated. One undoubted result will be more litigation and increased costs in administering trusts. Beneficiaries seeking to free themselves of trusts provisions they do not like can simply argue that it is not in their economic interest and as a result, sue trustees who do not challenge this with the benefit of hindsight.

The rule will also drastically alter the role of the fiduciary. Instead of a trustee interpreting and enforcing the settlor's wishes, the fiduciary's new role will be to question and challenge trust provisions on an on-going basis to make sure they are in the beneficiary's best interest. The beneficiary's desires and intention will be paramount in guiding the trustee.

The rule will also undoubtedly provide a basis for beneficiaries to overturn an entire estate planning regime. It will limit the ability of settlors helping descendants achieve personal, moral, and spiritual development—essentially taking the incentive out of incentive trusts. Forcing diversification of trusts in most instances, it will defeat tax planning strategies such as life insurance trusts, GRATs, and family LLCs and affect the ability to pass the family business to the next generation.

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Likely, the biggest effect of the rule—when enough practitioners are aware of it—is that settlors will simply avoid it by establishing trusts in settlor-friendly jurisdictions. With a rule that so drastically changes our historic trust law, states vying for trust business will market themselves and attract settlors who wish to avoid the rule. Essentially, the Uniform Law Commission, whose central mission is making states' laws uniform, by including the rule in the UTC, undermines its very mission as states will likely reject the rule.

How to Stop the Benefit-of-the-Beneficiary Rule

Several states that have adopted the UTC have modified or repealed the Benefit-of-the-Beneficiary Rule to curtail its effect. To date, the states that have deviated from the Benefit-of-the-Beneficiary Rule are Ohio, New Hampshire, Georgia, New Jersey, Mississippi, Minnesota, Colorado, and Florida. For example, Ohio deleted the mandatory beneficiary rule under UTC § 105(b)(3) and replaced it with a more settlor-friendly default rule, in which the settlor can modify. Ohio Rev. Code Ann. § 5804.04 (West 2007). Likewise, New Hampshire deviated from the UTC by establishing that "the requirement that a trust and its terms be for the benefit of its beneficiaries *as their interests are defined under the terms of the trust.*" N.H. Rev. Stat. Ann. § 564-B:1-105(B)(3). This additional language softens the effects of the benefit of the beneficiary rule. Similarly, Minnesota and Mississippi allow the settlor to determine what constitutes the "interest of the beneficiaries" in the trust itself. M.S.A. § 501C.0103(b); Miss. Code Ann. § 91-8-801. Connecticut, one of the two states to introduce the UTC in 2018, proposed that "a trustee shall administer the trust in good faith, in accordance with the terms and purposes, settlor's intent and the interests of the beneficiaries…." An Act Concerning the Adoption of the Uniform Trust Code, https://bit.ly/34knDsp (last visited June 22, 2018). It is evident that other UTC states should consider similar amendments to their trust code and practitioners should pressure their state bar association and legislatures to do so. ■